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Article

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Steering the Unsteerable? Aggregate Fiscal Stance and Spillover Effects in the Euro Area

The concept of aggregate euro area fiscal stance and the underlying assumption of significantly positive cross-country fiscal spillovers is a highly debated topic. The European Commission seems intent on using this concept as a basis for introducing top-down coordination of European fiscal policies. This article argues that the spillover effects of fiscal impulses in one country to the rest of the euro area would be rather limited. Introducing fiscal top-down coordination would require a substantial shift of political competencies from member states to the European level. A discussion of potential changes to the current fiscal framework would need to be part of a wider debate on the future of the European Economic and Monetary Union.

The discussion about the aggregate euro area fiscal stance and the underlying assumption of fiscal spillover effects has been gaining traction recently. The concept is regularly debated by euro area finance ministers in conjunction with discussions about European fiscal surveillance over the budgetary planning of member states. It has also been discussed in a great number of publications on fiscal policy in the euro area.¹ At the same time, there is a wider international debate about whether fiscal policy should assume a greater role in influencing the economic cycle in times when monetary policy has reached the zero lower bound. While the fiscal stance is a concept with no universally accepted definition, the term usually refers to the orientation of fiscal policy, which may be labelled as expansionary, restrictive or neutral. A neutral fiscal policy

would be one in which national fiscal policy neither supports nor drags on the national economy.²

In 2016 the European Commission issued a communication based on an analysis of the euro area fiscal stance in which it suggested a fiscal stimulus of 0.5% of euro area GDP to support the economic recovery in the euro area. The Commission argued that expansionary fiscal policy in countries with fiscal space would support the European economic recovery and exert positive spillovers on euro area countries in need of stabilisation. It was assumed that under certain circumstances a coordinated rise in public spending by one per cent of GDP in the Netherlands and Germany, maintained for ten years, would lead to spillover effects to other countries of up to 0.5% of GDP.³

In November 2017, the Commission suggested a broadly neutral fiscal stance, but with a different composition. Member states with fiscal leeway should engage in higher public spending, while member states with sustainability concerns were advised to enhance consolidation efforts. This may imply that the Commission sees the concept of the European fiscal stance as an analytical base for giving advice to euro area member states on their fiscal policies. This article examines whether the concepts of a fis-

* The views expressed in this article are those of the authors and should not be reported otherwise.

1 One of the mandates of the newly created European Fiscal Board is to advise the European Commission on the appropriate fiscal stance for the euro area. See European Fiscal Board: Annual Report 2017, European Commission, 2017; and European Fiscal Board: Assessment of the prospective fiscal stance appropriate for the euro area, European Commission, 2017.

2 For details, see European Commission: Report on Public Finances in EMU, Institutional Paper 045, Luxembourg 2016, Publications Office of the European Union; and European Fiscal Board, *op. cit.*, pp. 46-47.

3 The recommendation was part of the Commission's first draft of policy recommendations to the euro area within the EU's economic and fiscal policy coordination process, the European Semester. See European Commission: Towards a positive fiscal stance for the Euro Area, COM(2016) 727 final, November 2016.

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cal stance and spillover effects is suited as a solid basis for policy advice on coordinating European fiscal policy. It analyses whether the concept is economically effective, democratically legitimate and politically feasible.

Aggregate fiscal stance steering under the euro area fiscal framework

The Commission bases recommendations to the euro area, which are later to be approved by the European Council, on Articles 121(2) and 136 of the Treaty on the Functioning of the European Union. Article 121 states that economic policies have to be regarded as a matter of common concern and provide a basis for “broad guidelines of the economic policies of the Member States and of the Union”.⁴ Article 136 gives a specific basis for policy guidelines for the euro area member states. According to the so-called Two-Pack Regulation, introduced in 2013 to strengthen euro area budget surveillance, “the Eurogroup should discuss the budgetary situation and prospects for the euro area as a whole”.⁵

Beyond these rather general legal sources that foresee a discussion of the budgetary situation and prospects for the euro area as a whole, there is no clear mentioning of the concept of the aggregate European fiscal stance in the common fiscal rules framework. The existing rules focus primarily on the individual country level, dealing with sustainability concerns. This framework reflects the concern that unsustainable fiscal policy in one or several member states can have negative external spillovers into other euro area countries. Fiscal policy coordination in the euro area is hence organised in a manner that is asymmetric by design: there are rules that request member states to respect certain limits for spending or national debt, but there are – intentionally – no rules whereby member states can be obliged to engage in additional spending.

Within the limits of European fiscal rules, national fiscal decisions on taxation and spending remain a prerogative of national governments. Regarding the design of national fiscal policy, the Stability and Growth Pact leaves room for individual countries to engage in stabilisation policies, allowing countries to increase spending for macroeconomic stabilisation.⁶ If all euro area countries had sound public finances, they could themselves implement coun-

tercyclical policies that would by aggregation result in a countercyclical fiscal policy at the aggregate level.⁷ Targeting a certain level of an aggregate fiscal stance, as the Commission seems intent on doing, would mean a paradigm change in European fiscal policy coordination: the concept implicitly assumes competences for budgetary decisions at the central level. To a certain degree, it would link fiscal policies in one member state to the economic situation in another member state.

Given the national prerogative for budgetary decisions, it seems questionable whether it is legitimate within the existing framework to target an aggregate fiscal stance, which would require additional spending by some member states. With national governments in charge of budgetary decisions, discussions about a potential trade-off between stabilisation efforts and sustainability concerns should be led at a national level, where democratically elected governments can act according to the preferences of the national electorate. As a result, all efforts from the supranational level which aim to steer the aggregate fiscal stance raise general concerns about democratic legitimacy. It seems likely that such recommendations would be contested by many euro area member states, since such a top-down approach to European fiscal policy is not in line with the spirit of the current framework of fiscal rules.⁸

Even in fiscally highly integrated federal systems such as in Germany, the central government level does not have comparable competences. Targeting or steering a common European fiscal stance would require a shift of fiscal as well as related economic policy competencies to the European level to ensure proper responsibility and control. The overarching questions of whether there is a need for an economic stabilisation function at the central level and how this could be implemented would need to be discussed in a wider context, together with other issues relating to the future development of the monetary union. Within the current fiscal rules framework, the concept of an aggregate fiscal stance should not be seen as a theoretical basis for a second-best solution for the coordination of European fiscal policies ahead of a wider discussion on a fully fledged second stage of EMU deepening.

Fiscal stance as a policy variable

The euro area fiscal stance encompasses the national fiscal stances without information about its geographical

4 TFEU, Article 121(2).

5 European Commission: Report on ..., op. cit., pp. 113-176; and European Parliament: Regulation (EU) 473/2013 of the European Parliament and of the Council, Recital 23, 27 May 2013.

6 For an overview, see C. Kamps, J. Cimadomo, S. Hauptmeier, N. Leiner-Killingler: Reflections on the Euro Area Fiscal Stance, in: *Intereconomics*, Vol. 52, No. 3, 2017, pp. 125-131.

7 See E. Ademmer, C. Boeing-Reicher, J. Boysen-Hogrefe, K. Gern, U. Stolzenburg: Euro area fiscal stance: definition, implementation and democratic legitimacy, In-Depth Analysis, European Parliament, Economic Governance Support Unit, 2016.

8 Ibid.

Figure 1
Differences in output gap estimates for euro area countries

in % of potential GDP



Sources: European Commission; IMF; OECD.

composition or the national choice of revenue mechanisms and expenditure items.⁹ In communications on the aggregate euro area fiscal stance, the Commission essentially argues that its composition is not ideal and that the existence of positive spillovers from higher public spending in some countries on other euro area countries would merit an adjustment of national fiscal policies. These arguments and the issuing of the country-specific recommendations for the eurozone in November (six months before the country-specific recommendations for individual countries) imply that the concept of the aggregate fiscal stance is to a certain degree seen as an analytical basis for a top-down approach to European fiscal policy, with the aim of cross-border stabilisation. Once a decision about the aggregate fiscal policy orien-

⁹ For a detailed definition of the concept, see European Commission: Report on ..., op. cit.

tation is taken, it can be broken down at the individual country level, which may result in recommendations to change national fiscal policies.¹⁰ In addition to the previously mentioned concerns regarding the implementation and democratic legitimacy of such an approach, there are several other potentially worrisome matters related to this approach.

First, the concept implicitly assumes that the discretionary use of fiscal policy for influencing the economic cycle is effective. A full discussion of this question is beyond the scope of this article. One can nevertheless draw the careful conclusion that due to well-known measurement and

¹⁰ See Giavazzi, who advocates a top-down approach: F. Giavazzi: Euro-area fiscal stance: definition, implementation and democratic legitimacy, In-Depth Analysis, European Parliament, Economic Governance Support Unit, 2016.

timing problems, discretionary fiscal policy intervention at the aggregate level only makes sense in periods of deep crisis when the hands of national policy makers are tied by budget constraints.¹¹ Figure 1 illustrates variations between output gap estimates by several international institutions for large euro area countries. Particularly in recent years, differences between estimates reach values of up to three percentage points, making an informed judgement about a country's position in the cycle difficult. In addition, looking at OECD and European Commission output gap estimates, the German Council of Economic Experts finds evidence for substantial *ex post* revisions of estimates for large euro area countries.¹² This illustrates the general real-time measurement problems related to adequately estimating cyclical positions, implying serious challenges for fiscal policy interventions aimed at smoothing cycles.¹³ Therefore, in normal times, it seems rather advisable to rely on the use of national automatic stabilisers in efforts to smooth the cycle. The only valid case for engaging in cross-border stabilisation efforts is the rare case of severe economic downturns, when national budgetary leeway is constrained.

Second, using a top-down approach may result in national policy advice that is not suitable for individual countries, which could imply national welfare losses. Asking countries with fiscal room for manoeuvre to engage in expansionary policy beyond their business-cycle needs runs the risk of leading them to a situation of overheating and depleting their fiscal buffers. These may be urgently needed to deal with future downturns or with medium-term challenges to the health of national public finances. Recommendations based on the concept of the aggregate fiscal stance may also lead to country recommendations aimed at increasing stabilisation efforts and focusing less on sustainability concerns, which may imply substantial risks for individual countries and the euro area as a whole.¹⁴ In addition, the concept of a fiscal stance is solely focused on the demand side. However, to sustainably improve economic performance of euro area countries, structural weaknesses have to be addressed.

Third, recommendations solely based on this analysis could be in conflict with obligations based on the exist-

ing European fiscal rules, in particular the Stability and Growth Pact. The wisdom of such a policy move is questionable, since it could over time result in a subsequent erosion of credibility when the application of commonly agreed rules is called into question.

Fourth, there is as yet no political consensus for adopting the fiscal policy coordination approach in the euro area. Therefore, continuously applying the concept runs the risk of provoking severe criticism from member states, which may see this as interfering with their national budgetary prerogative under the current legal framework.

In sum, the analytical concept of the European fiscal stance is a useful concept which delivers additional information for economic analysis. However, it is doubtful whether the concept is a valid basis for policy recommendations that require national fiscal policy changes. Country-specific needs are not properly taken into account, and national budgetary prerogatives are ignored.

Spillover effects of higher public investment

The euro area fiscal stance debate is built on the assumption of significant positive spillover effects. It is argued that higher public investment in euro area countries with fiscal leeway will contribute to stronger economic growth in other euro area countries. The underlying cross-border transmission is driven by a positive trade effect. Higher public investment in some euro area countries will lead to rise in their demand for exports from other euro area countries, which in turn will cause their GDPs to rise. However, this positive trade effect could be mitigated by possible monetary channel responses to the stimulus, such as interest rate or exchange rate adjustments. With the fiscal stimulus pushing price levels in the euro area upwards, the European Central Bank might have to raise interest rates in order to fulfil its mandate. The higher interest rate levels would weaken investment and consumption, reducing the import demand in the countries giving the stimulus. Higher interest rate levels can also trigger an appreciation of the (real) euro exchange rate, which would decrease exports and thereby economic growth in the euro area.

Building upon these transmission channels, a number of studies quantify the possible spillover effects of higher public investment, as shown in Table 1. Most of the studies which are frequently quoted in the debate on fiscal stance and fiscal spillovers compare the size of spillover effects with and without monetary policy responses. While the second scenario considers the import-demand channel only, the first scenario also accounts for interest rate and exchange rate adjustments.

11 See C. Kamps et al., op. cit.

12 See German Council of Economic Experts: Für eine zukunftsorientierte Wirtschaftspolitik, Jahresgutachten 2017/18, p. 103, based on data published by the European Commission and the OECD.

13 See S. Elstner, H. Michaelis, C.M. Schmidt: Das leere Versprechen der aktiven Konjunktursteuerung, in: Wirtschaftsdienst, Vol. 96, No. 8, 2016, pp. 534-540. For a detailed discussion of problems related to the measurement of output gaps, see Deutsche Bundesbank: Zur Verlässlichkeit der Schätzungen internationaler Organisationen zur Produktionslücke, Monthly Report, April 2014, pp. 13-38.

14 See E. Ademmer et al., op. cit.

Table 1
Studies on fiscal spillovers in the euro area

Study	Fiscal impulse	Monetary response	Effect on euro area (EA) GDP
Bundesbank (2016)	1% of GDP, 2 years, in Germany	No	0.26% in EA incl. Germany, country effects vary
		Yes	0.18% in EA incl. Germany, country effects vary
In't Veld (2016)	1% of GDP, 10 years, in Netherlands and Germany	No	0.3-0.5% in EA excl. Netherlands, Germany
		Yes	close to zero for EA excl. Netherlands, Germany
Bańkowski and Ferdinandusse (2017)	1% of GDP, 2 years, in Germany	No	0.28% in EA excl. Germany
		Yes	0.04% in EA excl. Germany
Elekdag and Muir (2014)	1% of GDP, 2 years, in Germany	No	0.2% in stressed EA, 0.3% in other EA
		Yes	0.13% in stressed EA, 0.22% in other EA
Beetsma et al. (2016)	1% of GDP, in Germany	-	0.4% in Austria, Belgium, Netherlands; lower effects in other countries, such as 0.06% in Greece
Ricci-Risquete and Ramajo-Hernández (2015)	-1 st. dev. in public expenditure, in Germany	-	Limited effects in EA, not further specified

Note: Fiscal spillover effects are not directly comparable due to different model settings.

Sources: Authors' own elaboration.

Applying the National Institute's Global Econometric Model (NiGEM), a multi-country macro model with New Keynesian features, the Bundesbank examines the size of spillover effects from an increase in German public investment of one per cent of GDP for two years.¹⁵ With no monetary response, the study finds spillover effects of a 0.26% increase on average in real GDP for the euro area, including Germany. If one were to subtract the German multiplier effect of the stimulus (0.52%) from this result, the spillover effects would be much lower. The country distribution of the spillover effect is uneven. While stronger effects are shown for countries with closer trade relations to Germany, such as the Netherlands (0.32%)

15 See Bundesbank: The international spillover effects of an expansion of public investment in Germany, Monthly Report, August 2016, pp. 13-17.

and some Central and Eastern European countries such as Slovakia (0.36%) and the Czech Republic (0.30%), country-specific effects on other euro area countries remain comparatively low, e.g. in France (0.11%), Italy (0.09%), Spain (0.10%) or Portugal (0.15%). When one includes monetary responses, the spillover effects decline. An increase in short-term interest rates causes spillover effects to the euro area, including Germany, to fall to 0.18%, with France (0.04%), Italy (0.03%), Spain (0.02%) and Portugal (0.07%) all seeing very small gains. The Bundesbank argues that these effects could still be exaggerated, for two reasons. First, spillover effects would be expected to further decrease if the stimulus were financed by tax increases instead of debt. Second, if the public investment consists of a lower – and possibly more realistic – level of imports, a further decline in spillover effects would be expected.

Based on a structural macro model (QUEST), in't Veld examines the size of spillover effects from a coordinated Dutch-German increase in public investment of one per cent of GDP for ten years and then gradually declining.¹⁶ With no or only a hesitant monetary response, spillover effects of 0.3% for the rest of the euro area are found. The study also shows that spillover effects could theoretically increase to 0.5% if the stimulus is shifted to investment in so-called core-capital with higher output effects, such as transport infrastructure and basic facilities like roads, railways or water facilities.¹⁷ With the inclusion of monetary responses, spillover effects to the rest of the eurozone are much lower.

Bańkowski and Ferdinandusse apply a large-scale micro-funded model (EAGLE) to quantify the spillover effects of a one per cent of GDP fiscal impulse in Germany for two years.¹⁸ With no monetary responses in the first two years, spillover effects to the euro area excluding Germany of 0.28% are found. With monetary policy responses, the spillover effects decrease to 0.04%.

Elekdag and Muir use a multi-region dynamic stochastic general equilibrium (DSGE) model (GIMF), consist-

16 See J. in't Veld: Public Investment Stimulus in Surplus Countries and their Euro Area Spillovers, Economic Brief 016, European Commission, 2016.

17 For this case, no investment in non-core public capital with lower short-term output effects such as health, education or public buildings is assumed. For further details on core and non-core public capital, see P. Bom, J. Ligthart: What have we learned from three decades of research on the productivity of public capital?, in: Journal of Economic Surveys, Vol. 28, No. 5, 2014, pp. 889-916.

18 See K. Bańkowski, M. Ferdinandusse: Euro area fiscal stance, ECB Occasional Paper No. 182, European Central Bank, 2017; and S. Gomes, P. Jaquinot, M. Pisani: The EAGLE: A Model for Policy Analysis of Macroeconomic Interdependence in the Euro Area, ECB Working Paper No. 1195, 2010.

ing of the following six regions: Germany, stressed euro area countries, other euro area countries, United States, Emerging Asia and the rest of the world.¹⁹ With a German fiscal stimulus of one per cent of GDP for two years, peak spillover effects on the stressed euro area countries of 0.2% (other euro area countries: 0.3%) in case of no or limited monetary channel responses are found. With monetary responses, spillovers decline to 0.13% (other euro area countries: 0.22%). Whereas smaller DSGE models derive macroeconomic transmission channels of fiscal spillover effects very clearly, theoretical assumptions are more restrictive than in the studies mentioned above. Thus, applicability to policy consulting in terms of quantifying the specific size of possible fiscal spillovers in the euro area seems rather limited.²⁰

Beetsma et al. apply a panel vector autoregression (VAR) model and a bilateral panel trade model (gravity model) including 14 EU countries for the time period 1965-2004 to estimate fiscal spillover effects in the euro area.²¹ An increase in German public spending by one per cent of GDP has strong spillover effects of 0.4% on the neighbouring countries Austria, Belgium, Luxembourg and the Netherlands after two years. In line with the gravity model assumptions, spillover effects in countries that are further away are substantially lower. Using a global VAR model including 12 euro area countries for the time period 1979-2009, Hebous and Zimmermann show that an EMU-wide fiscal impulse has a higher impact than a domestic impulse of the same size.²² Ricci-Risquete and Ramajo-Hernández apply a similar VAR model including 14 EU countries and the United States.²³ For a reduction of German public expenditure by one standard deviation, they

find limited spillover effects. Most VAR models do not explicitly specify if there is a monetary response or not. Their observation periods encompass different exchange rate regimes and the introduction of the Maastricht rules. The empirical results are hard to compare due to different model settings.

Conclusions

The literature on the spillover effects of higher public investment in the euro area does not provide clear support for policy recommendations based on the aggregate fiscal stance. The studies' results seem to depend on several critical assumptions. First, the assumed fiscal impulse is substantial. An increase in public investment in Germany by one per cent of GDP would represent approximately a 50% rise over 2016 funding levels. Second, the size of spillover effects crucially depends on accommodative monetary policy. However, given the size of the assumed fiscal stimulus, it seems unlikely that it would not lead to early monetary responses. Third, tax financing instead of debt financing the stimulus would lead to lower spillover effects.

At the current level of EMU integration, the fiscal stance concept should not be used as a basis for a top-down approach to European fiscal policy coordination or for fiscal policy advice to individual countries. The current fiscal framework foresees policy coordination which is focused on increasing the resilience of individual member states by ensuring the sustainability of their public finances. A main intention of this asymmetric framework is to avoid negative external spillovers from unsustainable fiscal policy in one country to other countries, an occurrence for which there is substantial historical evidence. Moving to a top-down approach would require a shift of competencies to the European level to ensure proper responsibility and control. In particular, a credible application of the concept would require competencies at the central level to exert control on national budgetary decisions that are beyond the current fiscal framework.

Such an approach would require a wider debate on the future of EMU. As long as there is no common understanding about a second stage of EMU deepening, the fiscal stance concept provides a questionable basis for European policy coordination. Credibly applying the concept would require giving the central level responsibility and control for both fiscal and related economic policies. A discussion about shifting responsibilities to the central level needs to be an integral part of a wider debate on EMU deepening.

19 See S. Elekdag, D. Muir: *Das Public Kapital: How Much Would Higher German Public Investment Help Germany and the Euro Area?*, IMF Working Paper No. 227, 2014.

20 See O. Blanchard, C. Erceg, J. Lindé: *Jump-Starting the Euro Area Recovery: Would a Rise in Core Fiscal Spending Help the Periphery?* NBER Macroeconomic Annual 2016, Vol. 31, 2017, University of Chicago Press, pp. 103-182. The fiscal stimulus originates in the core country, which is twice the size of the periphery country. The core country's price levels increase compared to the periphery country. The periphery country's improved terms of trade trigger stronger exports to the core country, which in turn increases the periphery country's GDP. The terms-of-trade effect may be lower in an open economy setting, as trade with third countries could mitigate direct effects. For more details, see O. Blanchard: *Do DSGE Models Have a Future?*, Peterson Institute for International Economics Policy Brief No. 11, 2016; and H. Uhlig: *Discussion of Blanchard-Erceg-Lindé*, Working Paper, 2016.

21 See R. Beetsma, M. Giuliodori, F. Klaassen: *Trade Spill-Overs of Fiscal Policy in the European Union: A Panel Analysis*, in: *Economic Policy*, Vol. 21, No. 48, 2016, pp. 641-687.

22 See S. Hebous, T. Zimmermann: *Estimating the effects of coordinated fiscal actions in the euro area*, in: *European Economic Review*, Vol. 58, 2013, pp. 110-121.

23 See A. Ricci-Risquete, J. Ramajo-Hernández: *Macroeconomic effects of fiscal policy in the European Union: a GVAR model*, in: *Empirical Economics*, Vol. 48, No. 4, 2015, pp. 1587-1617.